ACCOUNTING IN PUBLIC SERVICE REGULATION

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In the practical working of commissions charged with regulating the operations of corporations engaged in selling service to the public, commonly known as public service corporations, scientific accounting is indispensable, and is the substantial foundation upon which the whole structure of regulation must be based. This fundamental truth is not thoroughly appreciated by either the public or the corporations interested, but a careful analysis of the practical working of regulation will demonstrate the undeniable correctness of the assertion.

Public service regulation as it now exists in the large part of the states covers the three great subjects of capitalization, rates and service. The term capitalization embraces the authorization by the commission to issue stocks, bonds, or other long time securities for the purpose of obtaining money for proper capital purposes. In case the application is for leave to issue such securities for the purpose of obtaining money for construction yet to be performed, the amount required is necessarily the subject of estimate. No method can be devised for determining in advance the precise cost of any physical work. The amount authorized by the commission, therefore, is necessarily approximate only to the real cost; it may be greater or less than such cost. The important point in this class of applications is to know, when the work is performed, how much has been really expended thereon and whether such expenditures have been made in a proper manner. If the cost proves to be greater than the estimate, additional funds must be supplied and if the cost proves less than the estimate, it then becomes necessary to determine what use or application should be made of the excess amount. In this class of applications nothing is easier than for the corporation if it be so minded to obtain authorization to procure money for one purpose and, when so procured, to use the money for other purposes than those specified in the authorization. Not all corporations would be guilty of this conduct, but some have been and doubtless others will be. This

fact and the necessity for supplying additional money if any be required and disposing of the surplus money if any there be, make it imperative that the authorization order shall provide for specific and detailed reports of the disposition made of the money, which reports, to be of any value, must be based upon accurate accounting. Such reports can be checked and their truthfulness verified only in cases where the accounting has been according to a proper system, enabling the examiner to verify the statements with complete accuracy.

In another class of capitalization cases the expenditure has already been made by the corporation from income or from moneys obtained by the issue of short-time securities for which authorization by the commission was not required by law. The company seeks by the issue of bonds to obtain funds to reimburse its treasury for the expenditure made, or to obtain the means of liquidating short time notes. A case of this class may cover expenditures running over a series of years and embracing many different classes. Unless there has been careful accounting during the progress of the work, it is impossible for the commission to ascertain whether the expenditures were in fact made for capital or other purposes. This is particularly true in the case of betterments which generally involve expenditures for replacements. Replacements are chargeable to operating expenses and are not capitalizable. Unless the corporation is required to observe with great care strict accounting rules with reference to replacements, it is possible in such an application to procure the capitalization of matters which should have been charged to operating expenses. In the case of corporations whose financial affairs are not in the most flourishing condition, there is great temptation to do this, especially if there appear to be urgent reasons for maintaining a given rate of dividend. A proper system of accounts rigidly enforced is essential and indispensable in all these and other cases which it is unnecessary to describe at this time.

In rate making a proper accounting is also indispensable. The theoretical basis of rates is that the corporation is entitled to such rates as will enable it to earn its operating expenses, a fair return upon the amount of its investment and such further return as will compensate it for property worn out or destroyed in the service. Unless its operations produce earnings to an amount sufficient for all these purposes, the corporation is on the sure road to bankruptcy. That bankruptcy may be delayed until its property or some sub-

stantial part thereof is worn out. If it then finds that it has no funds in hand, derived from earnings, with which to replace such worn out and destroyed property, its condition at once becomes serious. As to operating expenses the corporation is not fairly entitled to charge the public with extravagant expenditures or for inefficiency in operation. Accordingly, wherever it is possible in rate making, it is incumbent upon the commission to inquire into the operating expenses and ascertain whether they are such as should properly constitute a charge against the public. Accounting alone will not enable the commission to determine any such question, but without accounting the effort would be hopeless. With accounting supplemented by other investigations, a result reasonably approximate to correctness may be obtained.

The wearing out or destruction of property in the public service, involving as it does the element of depreciation, is at present the most difficult and obscure problem in accounting. It is obvious that no accounting rule can be laid down for the handling of depreciation without taking into account the facts which constitute depreciation, that is to say, how long any given piece of property will continue fit for the service. The life, as it is termed, of property in service is variable for articles of the same class. It is variable in different localities. It varies, of course, with the amount of service required in a given period of time. If follows that the experience of one company may be different from the experience of another and it is also true that the experience of the same company for different periods of time may be different. No records of experience have been preserved which would enable a commission to make any hard and fast rules with regard to the amount of depreciation which should be written off annually. This amount at best can be only an approximation and such approximation must be made from the experience of the corporation itself. If the corporation should create too large a depreciation reserve, something which is not unknown, the result is that the public unjustly suffers in the rate. If the corporation does not create a sufficient reserve, sooner or later it must suffer when its plant needs substantial renewal. It is not the purpose at this time to point out the various intricate problems arising in the treatment of depreciation. It is needful only to say enough to call attention to the fact that depreciation is essentially an accounting problem, and one which must be dealt with in some manner in the accounts of

the corporation, and the manner in which it is handled should always be known to and approved by the commission which undertakes to regulate rates.

This problem of depreciation is also in evidence in cases of capitalization, especially where the corporation seeks to reimburse its treasury for moneys expended from income. It is impracticable in many cases to determine how much has actually been expended for capital purposes without tracing out and thoroughly checking the treatment accorded by the corporation to depreciation.

In service matters it is plain that no service can be required which the revenues of the company do not justify. This does not mean that no service should be required which does not give a return equal to its cost, including in cost all proper overhead charges. Upon this point great difference of opinion exists and it is not designed to bring it into discussion at this time. A sufficiently accurate statement probably is that there is such a relation between service and revenue as to make it imperative to consider the cost of a new service which the commission contemplates requiring and of an existing service which the company contemplates discontinuing. It may very well be that such a service is one which the company is bound to render irrespective of the profit or loss resulting therefrom; and on the other hand it may be such that, unless the company can reimburse itself for operating expenses out of that particular service, it should never be required. It requires no particular discussion to demonstrate that the cost of service is an element to be considered in all cases. There is, however, nothing harder than to ascertain, where a variety of service is afforded, especially in railroad practice, the cost of a given service. It is made up of so many elements and is so intertwined and commingled with the cost of other services that it is at times beyond the power of any accounting schemes which have yet been devised to ascertain such cost with accuracy. Nevertheless, although perfection may not be obtained, the best approximation which can be made is always desirable if not indispensable.

One most important element of regulation is that there should be complete publicity of all corporate financial transactions. This is essential for the general public as well as for the stockholders and creditors of the corporation. Long and bitter experience has taught the truth of this observation to all; and no one now disputes either the propriety or the necessity of such publicity. There can be no

true publicity without correct accounting. Balance sheets as usually made up and published are worthless, not to say misleading, unless the basis upon which they are prepared is known and that basis is rigidly adhered to. In many cases it is easy for a skilled accountant to determine by glancing at its balance sheet that a corporation which apparently is in a prosperous condition, is really insolvent. The general public cannot do this. But very few people outside of trained accountants know how to read a balance sheet. For many years in one of the states, railroad corporations were required to report to the state certain details of their corporate transaction. They were not required, however, to keep accounts by a uniform system, nor were they required to report a balance sheet. Investigation has demonstrated that, because of these facts, the reports thus made to the public were practically worthless in many cases for the purpose of determining the true financial condition of the corporation. No one can tell the real condition of a corporation, not even its own directors, without knowing how depreciation is handled in the accounts.

From these considerations it follows that to make publicity of substantial value, the accounts of corporations of a given class must be kept uniformly and according to a prescribed system. It is not always easy for the most skillful accountant to determine the proper classification of an expenditure, but unless we know what system of classification the accountant is following we can know but little or nothing of what his accounts really mean.

Public service laws generally require that the commission shall keep informed as to the financial condition of corporations under their jurisdiction. It is obvious that they cannot obey such a provision of law unless they have control of the accounting methods of the corporation. This one fact makes it imperative that commissions should prescribe uniform systems of accounts. It is greatly desirable that these systems should be uniform throughout the country and should not vary in essential matters in different states. This is clearly demanded for the protection of the investors. Corporate reports and official compilations of such reports are not understandable except as the system of accounting from which they are compiled is known. Once a uniform system of accounting is adopted and prescribed it is generally assumed that it will be observed correctly by the corporations to which it applies. This is not the case. Large

numbers of the managers of minor corporations have never received any training in accounting and think that it is nothing but bookkeeping; have no conception of accounting problems and remit the whole matter to some low salaried bookkeeper. They do not understand the real function and importance of proper accounting in public service regulation and, what is most vital to them, in many cases, they do not understand its importance in their own corporate affairs. A bookkeeper with no training and inadequate experience becomes confused and discouraged and the whole matter is allowed to drift along in an uncertain shape until the corporation is obliged to make some application to the commission involving an examination of its accounts. The real situation is then discovered and ofttimes herculean efforts are required to pull the corporation out of the chaos into which it has thrown its own accounts. This is one of the practical results of the introduction of a new and uniform system of accounts without proper instructions and assistance given by the commission to the corporation.

In the case of large corporations the importance of accounting is usually most thoroughly understood, but in the case of some, their past financial history has been such that the introduction of a new system entails a severe wrench and is likely to bring to the front matters which they believe it would be far better to have unknown. There is with such corporations at times a severe struggle over the proper accounting disposition of matters which lie near the line of debate.

Reports to the commission are, of course, based upon the theory that accounts are kept in accordance with the prescribed system and the report is so drawn as to call for information which may easily be tabulated from the books of the corporation if correctly kept. Whenever the corporation has not kept its accounts in this manner, the making out of an annual report is an occasion of great trouble if not of mental agony. Some answer must be given to the questions, and the answer which would be perfectly easy if the books had been properly kept is almost impossible of ascertainment if they have been improperly kept. The not infrequent result is that the annual report is not much more than a series of guesses and conveys no reliable and accurate information upon many vital points. Checking in the office of the commission will disclose this and there follows a long correspondence extending through many months in what is frequently an

endeavor to get the correct answer and make the figures throughout the report harmonious and correct.

The situation here briefly outlined justifies the conclusion that there should be a periodical examination of the books of the corporation for the purpose of determining whether they are kept in accordance with the system. Such examination, when properly handled by an intelligent examiner, is of great assistance in enabling the smaller class and even many of the larger corporations to understand their own affairs. It is indispensable if correct reports and proper publicity of the affairs of the corporation are to be had. It is a melancholy fact that, without a prescribed system of accounts, the bookkeeping and accounting of large numbers of smaller corporations are deficient in the extreme. The writer has known of one instance of a street railroad corporation with operating revenues of approximately $100,000 annually, the entire bookkeeping of which consisted of an ordinary pocket bank pass book to show receipts, the stubs of the check book showing the disbursements and the time book showing the time of the men employed. This indeed was plain and simple, but the result was that the corporation itself had no proper understanding of its own affairs and the results which might be expected from management followed through a series of years. Legislators who are desirous that publicity should be enforced in the case of public service corporations should understand that publicity has no value without correctness; that correctness can only be attained by proper accounting and that proper accounting usually follows only from careful and systematic supervision, and that such supervision demands regular and careful examination of the books of the corporation. If such examination could be had, it would not make an end of corporate mismanagement, but that it would be a most important step in the improvement of conditions there can be no doubt.